No. 11,146

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

PACIFIC PUBLIC SERVICE COMPANY,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITIONER'S OPENING BRIEF.

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STATEMENT AS TO JURISDICTION.

This is a proceeding upon petition to review a decision of the Tax Court of the United States.

Petitioner filed its income tax return for the calendar year 1940 with the Collector of Internal Revenue at San Francisco.[1] On March 26, 1943, in compliance with Section 272 (a) of the Internal Revenue Code, respondent issued notice of his determination of a deficiency in income tax of petitioner for the calendar year of 1940 in the sum of $7,343.21 and sent to the petitioner by registered mail a notice of said deficiency.[2] Petitioner filed its petition for review[3] of that determination by the Tax

[1] R. pp. 5, 26.
[2] R. pp. 5, 26.
[3] R. pp. 1, 5-16.

Court of the United States and therein alleged that there was no deficiency and alleged an overpayment of $30,488.15. Respondent filed its answer,[4] the matter was heard by the Tax Court and on April 20, 1945, the Court entered its decision, pursuant to its opinion,[5] determining an overpayment by the petitioner in the amount of $117.82.

On July 20, 1945, petitioner filed its petition for review of that decision by this Court and served notice thereof upon respondent in accordance with the provisions of Sections 1141 and 1142 of the Internal Revenue Code, and Rule 30 of this court.

STATEMENT OF THE CASE.

One issue is involved in this case. Was petitioner's unsecured note of the California Consumers Company for the face amount of $478,270 a "security" within the meaning of Section 112 (b) (3) of the Revenue Act of 1934 and Section 112 (l) of the Internal Revenue Code?

The facts are briefly as follows:

Petitioner was the owner of $75,000 principal amount of first mortgage bonds,[6] 902 shares of preferred stock,[7] and 25,000 shares of common stock[8] of California Consumers Company, a Delaware corporation, engaged in the ice and cold storage business in Southern California. In addition petitioner held an unsecured promissory note evi-

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[4] R. pp. 1, 26-30.
[5] 4 T.C. 87.
[6] R. p. 48.
[7] R. p. 48.
[8] R. pp. 47, 48.

dencing advances of $478,270 to said California Consumers Company.[9] In 1933 said California Consumers Company defaulted on its first mortgage bonds.[10] A complaint was filed for the foreclosure of its properties and the appointment of a receiver under the trust indenture securing the bonds. A receiver was appointed to operate the properties pending institution of proceedings under Section 77-B of the Federal Bankruptcy Act.[11] The receiver operated the properties from 1933 to 1935.[12]

In 1935 a reorganization plan was formulated and proposed by committees representing the bondholders, the preferred shareholders, and the petitioner as unsecured creditor.[13] This plan was approved by the bankruptcy court and was duly consummated,[14] through proceedings instituted under Section 77-B of the Bankruptcy Act. As provided in the plan of reorganization a new corporation, the California Consumers Corporation, was organized under the laws of California and to it were transferred all the properties of California Consumers Company for its stock and bonds and the assumption of certain liabilities of subsidiaries and affiliated companies.[15] The new corporation issued new 5% bonds in the same aggregate amount as the 6% bonds outstanding and 54,274 shares of new stock to the bondholders, shareholders, and unsecured creditor (petitioner) in the following proportions: 52% of the new shares were issued to the bondholders

[9] R. p. 48.
[10] R. p. 47.
[11] R. p. 47.
[12] R. p. 47.
[13] R. p. 45.
[14] R. p. 45.
[15] R. p. 45.

represented by participating certificates issued under the voting trust agreement, 42% were issued direct to the preferred shareholders and 6% to petitioner as unsecured creditor.[16] The common shareholder received nothing under the plan of reorganization.[17] In accordance with the plan petitioner received $75,000 in new bonds plus voting trust certificates for 600 shares of stock of the new company in exchange for its $75,000 of bonds of the old company, 1,353 shares of stock of the new company in exchange for its 902 shares of preferred stock in the old company and 3,287.5 shares of the new company in exchange for its unsecured note for $478,270.[18] No parties received any cash, warrants, or other consideration except bonds and stock of the new company.[19] No one other than the former bondholders, preferred stockholders, and petitioner as unsecured creditor received any interest in the new company.

Petitioner retained its stock and bonds in the new corporation until 1940 when they were sold on the open market for a price of $19,654.85.[20] Petitioner claims a loss of $564,494.56 on that sale.[21]

Respondent determined that the 1935 reorganization was not a tax-free exchange and that a loss should have been recognized to petitioner on the exchange in 1935 when

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[16]R. pp. 45-46, 59, 60.
[17]R. pp. 46, 62-63.
[18]R. p. 50.
[19]R. p. 46.
[20]R. pp. 44, 149.
[21]Petitioner's loss was determined as follows:

Cost of bonds.....	$ 54,877.66	Total cost	$584,149.41
Cost of preferred stock	51,001.75	Sales price 1940...	19,654.85
Cost of note	478,270.00	Loss sustained	$564,494.56
	584,149.41		

it acquired the stock and bonds of California Consumers Corporation in exchange for its stock and bonds and the note of the California Consumers Company.[22] Petitioner contended before the court below that there was a tax-free exchange in 1935 and that its basis for determining the loss on the sale in 1940 was its cost of the stock and bonds of California Consumers Company plus its cash advances to said company.[23]

The court below held that petitioner's exchange of bonds and preferred stock for new bonds and new stock of the California Consumers Corporation was a tax-free exchange within the scope of Section 112 (b) (3) and Section 112 (l) of the Internal Revenue Code[24] and that petitioner sustained no loss in 1935 on said exchange.[25] Therefore petitioner's basis for said bonds and stock carried over to the new bonds and stock[26] sold in 1940 and resulted in a loss which gave rise to the overpayment of $117.82 as determined by the Tax Court.

The court below also determined that petitioner's exchange of its demand note for stock of the new corporation was not a tax-free exchange because the demand note could not be claimed as a "security" within the meaning of Section 112 (b) (3) or Section 112 (l) of the Internal Revenue Code.[27] If said exchange were tax-free, peti-

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[22]R. p. 23.

[23]R. p. 157.

[24]Section 112 (l) of the code was added by Section 121 (b) of the Revenue Act of 1943 and was made retroactive to years beginning after December 31, 1931 by subsection (e) thereof.

[25]R. pp. 161, 163.

[26]Section 113 (a) (6) of the Internal Revenue Code as amended by Section 121 (c) of the Revenue Act of 1943.

[27]R. pp. 161-163.

tioner's basis for the new bonds and stock sold in 1940 would have included the amount of the demand note and increased petitioner's loss, giving rise to an overpayment of $30,488.15 claimed by petitioner in the court below.

SPECIFICATION OF ERRORS RELIED UPON.

Petitioner relies upon the following assignments of error:

The Tax Court of the United States erred:

1. In holding that the exchange by petitioner of the note of California Consumers Company for stock of the new California Consumers Corporation did not fall within the provisions of Section 112 (b) (3) of the Revenue Act of 1934;

2. In separating a single unified transaction, i.e., the 77-B reorganization of California Consumers Company in 1935 into four separate exchanges, certain of which were held to be tax-free and others of which were held subject to the recognition of gain or loss;

3. In holding that the note of California Consumers Company was not a "security" within the meaning of Section 112 (b) (3) of the Revenue Act of 1934 and Section 112 (l) of the Internal Revenue Code as added by Section 121 of the Revenue Act of 1943;

4. In holding that the exchange of the note of California Consumers Company for stock in the new company was not exempt from the recognition of gain

or loss under said Section 112 (l) of the Internal Revenue Code;

5. In that its decision is not supported by the evidence and is contrary to law.

SUMMARY OF ARGUMENT.

1. In an insolvency reorganization as contemplated by Section 121 of the Revenue Act of 1943, which added Section 112 (b) (10) to the Internal Revenue Code, no gain or loss is recognized under Section 112 (l) to any of the participating creditors of the insolvent corporation who receive in exchange for their original creditor-interests proprietary interests in the new corporation.

2. The term "securities" when referring to interests surrendered in an exchange described in Section 112 (b) (3) of the Revenue Act of 1934 or Section 112 (l) of the Internal Revenue Code does not have the same restrictive definition applied by the court in the *Pinellas*[28] case.

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[28] *Pinellas Ice Co. v. Commissioner* (1933), 287 U.S. 462.

1. NO LOSS WAS RECOGNIZED TO PETITIONER IN RESPECT OF ITS DEMAND NOTE FOR THE REASON THAT IN AN INSOLVENCY REORGANIZATION AS CONTEMPLATED BY SECTION 112 (l) OF THE INTERNAL REVENUE CODE, NO GAIN OR LOSS IS RECOGNIZED TO ANY OF THE PARTICIPATING CREDITORS OF THE INSOLVENT CORPORATION WHO RECEIVE IN EXCHANGE FOR THEIR ORIGINAL CREDITOR INTERESTS PROPRIETARY INTERESTS IN THE NEW CORPORATION.

The court below correctly determined that the 77-B reorganization of California Consumers Company in 1935 was a tax-free reorganization whether within the provisions of Section 112 (g) of the Revenue Act of 1934 or under the more recently enacted Section 112 (b) (10) of the Internal Revenue Code.

The court below also correctly determined that the exchange of preferred stock and bonds of the old company for stock and bonds of the new company was a tax-free exchange within the scope of the new Section 112 (l), as added by the 1943 Revenue Act.[29]

The lower court erred in holding that the unsecured note of the insolvent company was not a "security" within the meaning of Section 112 (l),[30] for the following reasons:

(a) Under Section 112 (l) no gain or loss is recognized to a creditor who succeeds to a proprietary interest in the new corporation under an insolvency reorganization.

(b) The rules applicable to "voluntary" reorganizations have no application under Section 112 (l).

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[29]R. p. 163.
[30]R. p. 163.

(c) The decision of the court below is in conflict with the result in another decision of the court below involving Section 112 (l).

(a) Under Section 112 (l) no gain or loss is recognized to a creditor who succeeds to a proprietary interest in the new corporation under an insolvency reorganization.

Section 112 (l) provides:

> "(l) General rule.—No gain or loss shall be recognized upon an exchange consisting of the relinquishment or extinguishment of stock or securities in a corporation the plan of reorganization of which is approved by the Court in a proceeding described in subsection (b) (10), in consideration of the acquisition solely of stock or securities in a corporation organized or made use of to effectuate such plan of reorganization."

The lower court was satisfied that all the conditions for the application of Section 112 (l) were present provided the petitioner exchanged "stock or securities".[31] In holding that the unsecured note was not a "security" within the meaning of Section 112 (l), the court below has misconstrued the intention of Congress in its enactment of Section 121 of the Revenue Act of 1943 and in particular the portion thereof which added Section 112 (l) to the Internal Revenue Code. The new legislation was inspired[32] by the decisions in *Helvering v. Alabama*

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[31]R. p. 164.

[32]Senate Finance Comm. Rept., 78th Cong., 1st Session, Rept. 627, pp. 49, 50.

Asphaltic Limestone Co.,[33] and its companion cases.[34] These cases all dealt with insolvency reorganizations under which creditors of the insolvent corporation acquired stock or securities of the new acquiring corporation. The Supreme Court laid down certain principles: When creditors take steps to enforce demands against an insolvent debtor they shift their interest from that of creditors to that of equitable owners of the corporate property, and from that time the former creditors have effective command over the disposition of the property. The proprietorship is not disrupted by the reorganization exchanges.

The clear intent of Section 121 of the Revenue Act of 1943 as it may be gleaned from the Congressional Committee Reports is that creditors of an insolvent corporation which undergoes a reorganization under Section 77-B of the National Bankruptcy Act who receive proprietary interests in the newly organized corporation in exchange for their creditor interests in the old shall recognize neither gain nor loss from the reorganization exchange.

Section 121 of the 1943 Revenue Act was first proposed to be added to the new law by the Senate. The Finance Committee Report[35] is replete with language indicating the intention of the Senate to cover situations exactly like the one presented by this case. In describing that portion of the amendment relating to the gain or

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[33] 315 U.S. 179.

[34] *Palm Springs Corp. v. Comm'r.,* 315 U.S. 185; *Bondholders Committee v. Comm'r.,* 315 U.S. 189; *Helvering v. Southwest Corp.,* 315 U.S. 194; see also *Helvering v. Cement Investors,* 316 U.S. 527.

[35] Senate Finance Comm., 78th Cong., 1st Sess., Rept. 627, p. 49 (Cum. Bull.—1944, p. 1010).

loss to the security holders under a transaction as covered by the new section, the Senate Committee said (p. 52):

> "Subsection (l) provides for the recognition of gain or loss upon an exchange of stock, securities, *or other obligations* of the old corporation for stock or securities in the new corporation. In order to provide uniform treatment in all cases regardless of the form of the particular transaction, the section provides that the acquisition of stock or securities in the new corporation and the relinquishment or extinguishment in connection therewith of stock, securities, *or other obligations* in the old corporation shall be deemed to be an exchange for the purposes of the subsection" (italics supplied).[36]

Clearly it was contemplated by Congress that situations would arise, such as presented here, where stock or securities and other obligations of the old corporation would be relinquished or extinguished in exchange solely for stock or securities in the new corporation. The purpose of the new provision would be thwarted if bondholders only are to have the benefit of the new provisions, while noteholders or persons subordinate to the bondholders in point of lien are to be denied the benefits of the section. Under the rules of the *Alabama Asphaltic Limestone* and *Cement Investors* cases, all the creditors of the insolvent corporation by virtue of the insolvency proceedings acquire equity interests. The purpose of the new law is to provide uniform treatment for all obligations of the type found here and to provide for nonrecognition of gain or loss to the creditors and shareholders of the corporation without restriction as to the particular form or term of

[36]Cum. Bull.—1944, pp. 1011-1012.

the creditors' interest in the insolvent corporation. For example, the Conference Committee Report says:

> "The new subsection provides for the nonrecognition of gain or loss to participating shareholders and *creditors* in a reorganization described in new section 112 (b) (10)" (italics supplied).[37]

Mindful of the basic requirement in tax-free reorganizations that there be a continuity of interest in the same persons before and after the exchange, the Senate Finance Committee expressly noted that the Supreme Court had held that:

> "upon an insolvency reorganization, where creditors of the reorganizing corporation succeed to the equity interests in the corporation, *the test of continuity of interest is sufficiently met* so that if the transaction otherwise falls within the definition of reorganization provided in section 112 (g)(1) * * * the transaction is one with respect to which *no gain or loss is to be recognized* * * *"[38] (italics supplied).

Congress, however, indicated its desire to enlarge the scope of the tax-free provision beyond those reorganizations contemplated by the Supreme Court by providing that:

> "The definition of 'reorganization' contained in section 112 (g)(1) of the code is specifically made inapplicable to a reorganization covered by the provisions on the new section 112 (b)(10)."[39]

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[37]Conference Comm., 78th Cong., 1st Sess., H.R. Rept. 1079, p. 10 (Cum. Bull.—1944, p. 1065).

[38]Senate Finance Comm., 78th Cong., 1st Sess., Rept. 627, pp. 49-50 (Cum. Bull.—1944, p. 1010).

[39]Conference Comm., 78th Cong., 1st Sess., H.R. Rept. 1079, p. 9 (Cum. Bull.—1944, p. 1063).

There is nothing in the new legislation or the committee reports to indicate that creditors of the old corporation who receive a proprietary interest in the new corporation by reason of the insolvency reorganization must hold creditor interests of a particular type in order to enjoy the non-recognition provision. It is significant that in the *Alabama Asphaltic Limestone* case the creditors held stock and *unsecured* notes. It was solely by virtue of their ownership of the unsecured notes that the creditors became the stockholders of the new corporation whose proprietary ownership dated back to the bankruptcy receivership proceedings. Under the interpretation by the court below of the new Section 112 (l), which section was inspired by the *Alabama Asphaltic Limestone* case, gain or loss would have been recognized to the creditors in the *Alabama Asphaltic Limestone* case.

Thus the form of the creditor's claim against the old corporation is unimportant so long as by virtue of the insolvency reorganization he acquires a proprietary interest in the new corporation. In other words, where creditor interests, of whatever form, succeed to proprietary interests in the new corporation "it conforms to realities to date their equity ownership from the time when they invoked the processes of the law to enforce their rights of full priority".[40] It conforms as well to realities to treat such an equity interest as arose from petitioner's note as a "security" for the purpose of the new Section 112 (l).

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[40]*Helvering v. Alabama Asphaltic Limestone Co.*, 315 U.S. 179.

(b) The rules applicable to "voluntary reorganizations" have no application under Section 112 (l).

The court below cites *Bunker Hill & Sullivan Mining, Etc. Co.*[41] *and Commissioner v. Sisto F. Corp.* (2d C. C. A),[42] for the proposition that the petitioner's note "was not of sufficient dignity to be considered a security".[43] Those cases involved *voluntary* reorganizations where there had not been an intervention by a court of equity. It is well settled that until a court of equity intervenes, the stockholders and creditors are not the owners of the corporate assets, notwithstanding the insolvency of the corporation. *Hollins v. Brierfield Coal & Iron Co.*[44] In *Helvering v. Cement Investors,*[45] the court specifically pointed out that ownership of the equity in the debtor companies effectively passes to the creditors when they institute receivership proceedings.

In the *Sisto* case the transferor exchanged notes in the X corporation for stock in the Y corporation to which the X corporation had transferred all of its assets in a *voluntary* reorganization. The Circuit Court for the Second Circuit concluded that the exchange was not tax-free, citing the *Pinellas* case for the proposition that the demand notes were not securities.

The *Sisto* case is no parallel to the case at bar. In the absence of the intervention of a court of equity, there was no continuity of interest between the taxpayer's status as noteholder of the old company and as stockholder in the

[41] 1 T.C. 1057, 1074.
[42] 139 F. (2d) 253.
[43] R. p. 161.
[44] 150 U.S. 371, 382, 383.
[45] 316 U.S. 527.

new company. As noteholder he held no proprietary interest prior to the exchange, as petitioner did here.

The Tax Court followed the decision in the *Sisto* case in the *Bunker Hill & Sullivan* case. In the latter case a debtor corporation transferred its assets, also in *voluntary* reorganization, to a new corporation in exchange for stock and distributed the stock in liquidation to its creditors and stockholders. The petitioner in addition to its stock held a demand note for advances to the old corporation and in the reorganization it received stock of the new corporation for its old stock although none was received in exchange for the note.[46]

The Tax Court held, citing the *Sisto* case, that petitioner in respect of the demand note was simply a creditor with no proprietary interest in the debtor corporation and that it therefore realized a bad debt on the note. The Tax Court also made it clear[47] that the rationale of the *Cement Investors* case and other cases involved in 77-B proceedings is inapplicable to voluntary reorganizations such as was involved in the *Bunker Hill & Sullivan* case.

(c) The decision of the court below is in conflict with the result in another decision of that court involving Section 112 (l).

The attention of the court is invited to one of the very few cases interpreting and applying the new Section 112(l), *Lothrop Withington*,[48] and one precisely in point here. In that case Section 112 (l) was held to apply where

[46] 1 T.C. 1057, 1059.
[47] 1 T.C. 1057, 1076, 1077.
[48] Tax Court Decision, May 30, 1944, C.C.H. Dec. 13,966(M).

under a 77-B reorganization exchange in 1935 the petitioner exchanged second mortgage bonds, preferred stock and *notes* of the old corporation for common stock in the new corporation. Petitioner sold his common stock in 1939. The Tax Court held that under the new Section 112 (l) petitioner's basis for the common stock was his original cost for the bonds, preferred stock and *notes*.

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2. THE RESTRICTIVE DEFINITION OF A "SECURITY" DERIVED FROM THE PINELLAS CASE HAS NO APPLICATION TO A SITUATION WHERE A CREDITOR INTEREST IS EXCHANGED FOR A PROPRIETARY INTEREST IN THE NEW CORPORATION.

The court below relied upon *Pinellas Ice Co. v. Commissioner*[49] in holding that petitioner's demand note was not a "security" within the meaning of Section 112 (b)(3) of the Revenue Act of 1934.[50] That section reads as follows:

> "No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization."[51]

The *Pinellas* case involved the transfer of its assets by the Pinellas Company to the Citizens Company for cash and short-term notes and the question which ultimately went to the Supreme Court was whether the Pinellas

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[49]287 U.S. 462.

[50]R. p. 162. Apparently that court's holding that the demand note was not a "security" within the meaning of Section 112 (l) was similarly grounded.

[51]Section 112 (b)(3) of the Internal Revenue Code is the same.

Company was taxable on the gain realized on the transaction, or whether the transaction qualified as a tax-free reorganization. The Supreme Court in holding that the transaction was nothing but a sale for cash and short-term notes and therefore did not qualify as a reoganization, introduced the "continuity of interest" theory as a test to eliminate those transactions which had "no real semblance to a merger or consolidation"[52] and to avoid a construction "which would make evasion of taxation very easy".[53] The court also held somewhat unnecessarily (and, in view of subsequent developments, somewhat unfortunately) that the notes were not "securities" within the meaning of Section 203 (b)(3) of the Revenue Act of 1926.[54] From this holding has emanated the misconception now seen in many decisions that in no case can notes qualify as "securities" for the purpose of the reorganization section.[55]

Generally, the decisions following the *Pinellas* case have concerned themselves with what was issued to the recipient by the "reorganized" corporation. The courts have taken literally the statement by the court in the *Pinellas* case that to enjoy an exemption from the recognition of gain, "the seller must acquire an interest in the affairs of the purchasing company more definite than that incident to ownership of short-term purchase-money notes".[56] As if the term "security" depended upon the length of time between the inception and the maturity of the obligation,

[52]287 U.S. 462, 470.
[53]*Pinellas Ice Co. v. Commissioner*, 287 U.S. 462, 469.
[54]This section is identical with Section 112 (b)(3) of the 1934 Act and the Internal Revenue Code.
[55]Sec. 112 (g).
[56]287 U.S. 462, 470.

the courts applied in various ways the test of length of time. *L. & E. Stirn, Inc. v. Commissioner;*[57] *Commissioner v. Freund;*[58] *Burnham v. Commissioner.*[59] This tendency to measure legal sufficiency on a time basis came before the Supreme Court in *LeTulle v. Scofield* (1940).[60] That case involved an exchange of properties by one corporation for cash and 10 year serial bonds of the transferee corporation. There the court took note of that tendency and in a sweeping opinion declared that the term of the obligation is not material and applied instead as a test whether after the reorganization the transferor *retained* a proprietary interest in the enterprise or *became* simply a creditor. If the interest *acquired* was that of a creditor the transaction did not constitute a reorganization.

The Supreme Court thus affirmed the "continuity of interest" principle after reviewing its development in the years subsequent to the *Pinellas* decision. It seems to be well settled by the *LeTulle* decision that in determining whether rights received pursuant to a reorganization constitute a "security" the test is whether they give the recipient a continuing interest in the enterprise different from that of a general creditor. Thus it became clear that any creditor interest received whether represented by notes or bonds and whether of short or long term is insufficient to meet the "continuity of interest" requirement.

It is petitioner's contention that there is a clear distinction between notes *given up* in an exchange for stock

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[57] 107 F. (2d) 390.
[58] 98 F. (2d) 201.
[59] 86 F. (2d) 776.
[60] 308 U.S. 415.

and notes *received* upon an exchange. It is the latter situation to which the *Pinellas* and *LeTulle* cases apply. The basis of their application is not that the notes are not "securities" but that they are not such "securities" as to fulfill the continuity of interest requirement.

This distinction was clearly perceived by the Circuit Court for the Seventh Circuit in *Burnham v. Commissioner of Internal Revenue*[61] involving a note *given up* in an exchange for stock. The court distinguished the *Pinellas* case and *Cortland Specialty Co.*[62] case when it held the exchange tax-free saying of those cases (p. 777): "It is obvious that both courts based their decisions not so much on the ground that the short-term purchase money notes were not securities as that the transactions involved were not reorganizations."

The seriousness of the misapplication of the *Pinellas* rule is most pointed where creditor reorganizations are involved. In virtually all of such reorganizations one side of the exchange is represented by creditor interests of one sort or another—bonds, notes, or other obligations. The holders of such interests generally receive stock and other securities in the reorganized or new corporation. To hold under the *Pinellas* or *LeTulle* cases that creditor interests on the transferor side of the exchange preclude the transaction from qualifying as tax free is in direct defiance of the Supreme Court's decision in the *Alabama Asphaltic Limestone* case.[63] As we have seen above that case held

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[61]86 F. (2d) 776; cert. denied 300 U.S. 683.
[62]*Cortland Specialty Co. v. Commissioner of Internal Rev.* (2d C.C.A., 1932), 60 F. (2d) 937; certiorari denied 288 U.S. 599.
[63]Supra pp. 9-10.

that upon an insolvency reorganization where creditors of the reorganizing corporation succeed to the equity interests in the corporation the test of continuity of interest is sufficiently met so that if the transaction otherwise falls within the definition of reorganization provided in Section 112 (g)(1), the transaction is one with respect to which no gain or loss is to be recognized.

Yet the lower court here lapsed into that error when it disregarded completely that petitioner's creditor interest survived in stock of California Consumers Corporation and ruled out the exchange on the ground that petitioner's note was not a "security" on the authority of the *Pinellas* case.

The same error was committed by the Circuit Court of Appeals for the Third Circuit in *Neville Coke & Chemical Co. v. Commissioner of Internal Revenue*[64] and by the Circuit Court of Appeals for the Second Circuit in *Bedford v. Commissioner of Internal Revenue*[65] both of which were decided this year. In both cases notes of the insolvent corporation were exchanged for stock of the new corporation in 77-B reorganizations. Yet both courts concluded that the notes were not "securities" under the totally inappropriate test of the *Pinellas* case and completely ignored the fact that in both cases the creditor interests had acquired by virtue of the bankruptcy proceedings a proprietary status for their creditor interests. In short, the courts in the two cited cases disregarded the important conclusion of the

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[64]148 F. (2d) 599.
[65]150 F. (2d) 341.

Supreme Court in the *Alabama Asphaltic Limestone* case while applying the artificial one sentence dictum of the *Pinellas* case.

If this position is correct then bonds which are simply creditor interests under the *LeTulle* case and hence are not "securities" when received in an exchange cannot be "securities" when given up in an exchange. The court below held otherwise.

This tendency of the courts to misapply the *Pinellas* case provoked a thoughtful article by Professor Erwin Griswold of the Harvard Law School in the Harvard Law Review for May, 1945. Petitioner respectfully invites the court's attention to this article which urges a re-examination of the concept "securities" inherited from the *Pinellas* case when the term is applied to notes or other creditor interests surrendered in an insolvency reorganization.[66] Professor Griswold sets forth the theory, previously put to the lower court by petitioner, but perhaps not so well stated:

> "It is herein argued, however, that the continuity of interest requirement should be concerned solely with what is received on the exchange, and not at all with what is given up. On this basis, it would follow that all creditors' reorganizations meet the continuity of interest test when the creditors end up as stockholders, regardless of whether the creditors were note holders or bondholders, or creditors on open account, and regardless of whether bankruptcy or receivership proceedings have actually been commenced."

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[66]Such a re-examination was frustrated when certiorari was denied in the *Neville Coke & Chemical* case, presumably because there is as yet no conflict with the 2nd and 3rd Circuits on the point raised by Professor Griswold and this petitioner.

Petitioner submits that this case is governed by the principle and holding of the *Alabama Asphaltic Limestone* case. In that case the Supreme Court examined the facts in the light of the rule of the *Pinellas* case—not the pseudo "notes are not securities" rule but the real rule, the "continuity of interest" test—and expressly found a continuity of interest in the unsecured noteholder who in the insolvency reorganization exchanged his note for stock in the new corporation. The continuity of interest was found to exist because the bankruptcy proceedings gave the noteholder a proprietary interest in the old corporation which carried over into stock of the new.

Mindful also of its own ruling in the *LeTulle* case that bondholder interests received in an exchange were creditor interests only and did not satisfy the "continuity of interest" requirement the court said in the *Alabama Asphaltic Limestone* case:

> "That conclusion involves no conflict with the principle of the *LeTulle* case. A bondholder interest in a solvent company plainly is not the equivalent of a proprietary interest, even though upon default the bondholders could retake the property transferred. The mere possibility of a proprietary interest is, of course, not its equivalent. But the determinative and controlling factors of the debtor's insolvency and an effective command by the creditors over the property were absent in the *LeTulle* case."[67]

Thus the Supreme Court itself has ruled that the *Pinellas* and *LeTulle* cases can have no application to a

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[67] 315 U.S. 179, 184.

situation where creditor interests which have acquired a proprietary status through the bankruptcy proceedings are exchanged for stock in the new corporation.

To summarize, the Supreme Court has recognized in the *Alabama Asphaltic Limestone* case and its companion cases (supra pp. 9-10, 19-20) that when bankruptcy proceedings are instituted, creditors thereby acquire by virtue of their creditor status proprietary interests in the insolvent corporation since "they are the real parties in interest".[68] It therefore becomes important to determine whether such proprietary interest is continued in the new corporation. Where stock of the new corporation is received for such creditor interest in the old, there would seem to be no question that a tax-free exchange has taken place.

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[68]Cement Investors, Inc., supra pp. 10 (f. 34), 11.